SECTION III:

OVERVIEW OF FINANCIAL PERFORMANCE: ANALYSIS AND INTERPRETATION

Overview of Financial Performance: Analysis and Interpretation

FINANCIAL STATEMENT REPORTING

HHS has prepared Departmentwide audited financial statements since FY 1996. Financial statements are also prepared for all OPDIVs (CDC's include ATSDR); the nine largest are audited. The audited OPDIVs account for virtually all HHS assets and expenditures. HCFA, FDA, CDC, and NIH do their own accounting and prepare their own financial statements. The Program Support Center (PSC) does the accounting and prepares the statements for the Office of the Secretary, Administration for Children and Families, Administration on Aging, Health Resources and Services Administration, Indian Health Service, Substance Abuse and Mental Health Services Administration and PSC. In addition to the Departmentwide audited statements, OMB only requires "stand-alone" audited financial statements for HCFA. However, HHS management believes that each OPDIV should take responsibility for its own financial management, and there is no better measure for financial accountability than a financial audit opinion from a professional independent third party. Therefore, we submit the financial statements of all but our smallest OPDIVs for voluntary audits. In order to complete our Departmentwide FY 1999 audit in a timely manner, audit resources were shifted. The result was that some OPDIV audits will not be completed until after the completion of the Departmentwide audit.

In this Accountability Report, HHS is presenting its Departmentwide FY 1999 audited financial statements. Readers are encouraged to refer to Section IV of this report for the actual financial statements, notes and supplemental schedules, and to the HHS FY 1998 Accountability Report for FY 1998 audited financial statements.

Definitions of Financial Statement Asset Categories

Entity Assets are those assets which the reporting entity holds and has the authority to use in its operations.

Non-entity assets are those assets which the reporting entity holds but does not have the authority to use in its operations.

Intragovernmental assets are those assets that arise from transactions among Federal agencies.

FINANCIAL STATEMENT AUDIT FINDINGS AND MANAGEMENT COMMENTS

Audit Opinions

Unqualified Opinion (Also known as a **"Clean Opinion"**) – Issued when 1) accounting principles used are appropriate, 2) disclosures are adequate, 3) data is presented in a reasonable manner, 4) underlying events and transactions are fairly reflected in the financial statements, and 5) the financial statements have not been materially affected by changes in accounting principles.

Qualified Opinion – Issued when there is 1) a lack of sufficient evidential matter, or 2) a departure from Generally Accepted Accounting Principles (GAAP).

Disclaimer of Opinion – Issued when the auditor has not collected sufficient evidential matter to form an opinion on the financial statements. The effects are so material that it would be inappropriate to issue a qualified opinion.

SAS 70 - a review of the internal control structure of an organization that processes transactions or accounts for assets or liabilities of another entity.

HHS received an unqualified, or "clean" audit opinion on the Departmentwide FY 1999 financial statements. This is a first for the Department, and a notable accomplishment over our FY 1996 disclaimer of opinion. For details, please see the auditor's opinion in Section V.

Individual OPDIV audit findings were not all finalized as this report went to print. When available, those reports will be posted to the respective OPDIV home pages. Those addresses are found on the inside front cover of this report.

Reviews in accordance with Statement on Auditing Standards (SAS) 70 were conducted during FY 1999 for several shared financial systems, and the auditors findings from those reviews were incorporated into the Departmentwide auditor's report.

In keeping with the U.S. CFO Council's "streamlining" philosophy of issuing one "accountability" document and one "planning" document per year, the Department's published Financial Management Five-Year Plan provides detailed information on our plans and goals for maintaining our "clean" opinion and resolving our audit findings.

Limitations of the Financial Statements

In accordance with OMB Bulletin 97-01, "Form and Content of Agency Financial Statements," we are disclosing the following limitations of the HHS FY 1999 financial statements, which are contained in this Accountability Report.

- The financial statements have been prepared to report the financial position and results of operations of HHS, pursuant to the requirements of the Chief Financial Officers (CFO) Act of 1990, as amended by the Government Management Reform Act (GMRA) of 1994.
- While statements have been prepared from HHS' books and records in accordance with the formats prescribed by OMB, the statements are different from the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.
- The statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

HHS Audit Findings History: FY 1996 – FY 1999

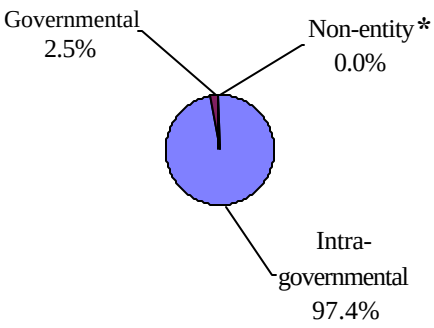
Issue Category	FY 1996		FY 1997		FY 1998		FY 1999	
	Qualification Causing Disclaimer of Opinion	Material Weakness	Qualification Causing Qualified Opinion	Material Weakness	Qualification Causing Qualified Opinion	Material Weakness	Qualifications	Material Weakness
Medicare Accounts Payable	X	X*		X				
SMI Revenue	X							
Medicare/ Medicaid Accounts Receivable	X	X*	X		X (includes Medicare contractor receivables only, excludes Medicaid)	X (includes Medicare contractor receivables only, excludes Medicaid)		X (includes Medicare contractor receivables only, excludes Medicaid)
Cost Reports	X		X					
Net Position	X	X	X	**				
Pension Liability	X							
Initial Audit	X							
EDP Controls		X		X		X		X
Grants Oversight and Accounting		X (includes oversight)	X (excludes oversight)	X (excludes oversight)				
Medicare Claims Error Rate		X		X				
Intra-Entity Departmentwide Transactions			X					
Financial Reporting				X**		X		X
New Statements					X			
TOTAL	7	5	5	5	2	3	0	3
Resolved From Prior Year	Not Applicable	Not Applicable	4	1**	4	3	2	0
New	7	5	2	1	1	0	0	0

* Consolidated into one material weakness citing both accounts payable and receivable in FY 1996.

** Net position issue from 1996 was consolidated into financial reporting issue in FY 1997.

ANALYSIS OF FINANCIAL POSITION (BALANCE SHEET)

HHS FY 1999 Assets



Most HHS assets are Medicare's claims on the U.S. Treasury, and are categorized as Intragovernmental.

*** Note: Non-entity assets were far less than .1% of total assets.**

ASSETS

HHS had over $271.6 billion in total assets (including non-entity assets) at the end of FY 1999, compared to $235.3 billion at the end of FY 1998. This 15.4% increase is due largely to increased balances in the Medicare Trust Funds and in Fund Balances with Treasury.

The balance sheet separately identifies intragovernmental assets from all other assets. The bulk of HHS' assets are intragovernmental, meaning that they are HHS claims against other Federal agencies. These are for accounts such as the Medicare Trust Funds' Investments in U.S. Treasury Securities and the Fund Balance at Treasury.

Assets Analysis by Account Type

Investments (at $184.8 billion) remains the largest HHS Asset. It is made up almost 68% of total assets at FYE 1999, compared to 69% ($161.9 billion) in 1998. These investments represent the cumulative excess of collections and appropriations over expenditures of the Medicare HI and SMI trust funds, which are invested with the U.S. Treasury Special Issue Securities. Treasury, in turn, uses these funds to finance other operations of the Federal Government thus reducing the need for Federal borrowing from the public. These securities had been accumulating since the inception of the Medicare program in 1966. According to the 1999 Trustees Report, 1995 was the first year that expenditures exceeded income and Medicare started to call upon its Trust Fund resources. These resources will continue to be called upon in years where annual expenditures exceed revenues.

Unlike the assets of private pension plans, Medicare trust funds do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. When financed by borrowing, the effect is to defer today's costs to even later generations who will ultimately repay the funds being borrowed for today's Medicare beneficiaries. The existence of large trust fund balances, therefore, does not make it easier for the Government to pay benefits. Reflecting both the law and existing Federal accounting standards, no liability is recorded for benefits which may be paid in the future on behalf of today's workers who are currently paying taxes into the trust funds and who expect to be future beneficiaries upon their retirement.

The next largest category of assets is ***Fund Balance with Treasury*** at approximately 27%, which represents other undisbursed balances (largely appropriated funds, but also amounts related to revolving and other funds) held at the Treasury Department (which acts as a sort of bank for HHS).

Accounts Receivable from the Public (Net), at $4.3 billion and ***Loans Receivable (Net)*** at $401 million represent a total of only 1.8% of HHS assets, but are the focus of a great deal of attention with respect to our debt collection initiatives, which are covered elsewhere in this report. Medicare's Contractor Accounts Receivable (which makes up the substantial portion of HHS Accounts Receivable) had been been the subject of a qualification in prior auditor's reports and presented a significant barrier to both HCFA and HHS "clean opinions" until a major effort was undertaken during FY 1999 to analyze and verify the subsidiary account records. The effort resulted in the write-off of $2.9 billion in Medicare contractor receivables. For further details, see financial statement footnote number four in Section IV.

Property, Plant and Equipment (PP&E), at almost $1.8 billion (net of accumulated depreciation) amounts to less than one percent of total assets, and is largely concentrated at NIH (numerous high technology research centers with high technology equipment), IHS (many facilities), FDA, and CDC. Since FY 1997, the capitalization threshold was increased from $5 thousand to $25 thousand, reducing the burden of accounting for smaller equipment purchases.

Assets Analysis by Budget Function

When assets are analyzed by budget function (see supplemental schedules in Section IV), Medicare (with its own budget function category) holds the vast majority (70%) of HHS assets (composed largely of the Trust Fund account balances). The health budget function (which covers the Medicaid program, NIH, HRSA, CDC, SAMHSA, IHS, FDA and AHCPR), the second largest (18%), is composed mostly of Fund Balances with Treasury, with lesser amounts attributed to Investments and PP&E.

LIABILITIES

Relative to HHS assets, there are few liabilities. This is because neither Federal law nor Federal accounting standards recognize any long term liabilities associated with covering future Medicare costs for today's workers contributing to the system today who become beneficiaries

upon their retirement. In other words, the amount of trust fund assets accumulated over more than three decades do not have an offsetting liability for future retirees.

Most of the HHS liabilities represent an estimate of accrued ***Entitlement Benefits Payable*** associated with the Medicare and Medicaid programs.

The noteworthy item in the HHS liabilities is the amount of ***Liabilities Not Covered by Budgetary Resources,*** which are largely unfunded pension expenses of the Commissioned Corp recognized at PSC, but also include accrued annual leave and disability compensation for employees at all OPDIVs. The inherent differences between the way funds are appropriated in the Federal budget process, and how they are accounted for under generally accepted accounting principles (GAAP) cause these unfunded liabilities. Budgets are formulated on more of a cash basis, while GAAP is on an accrual basis. In other words, financial (accrual) accounting recognizes that the cost of today's HHS employees consists of today's salaries and benefits actually received, as well as the accrual of benefits to be paid out at a later date (for a "full cost" amount). Budgetary accounting delays recognizing the earned but unpaid benefits for years, until the payments are actually made to the employees/retirees. The Federal budget process does not recognize the future employee benefits costs of today's employees, but instead budgets for those future expenses in the future years when they are actually paid. The result is that while employee expenses (present and future) are recognized in accrual-based financial statements, they are under-represented in the cash-based Federal budget. This is one excellent example of the benefits of accrual accounting financial statements; there are no surprises regarding liabilities for employee benefits.

NET POSITION: BALANCE SHEET AND STATEMENT OF CHANGES

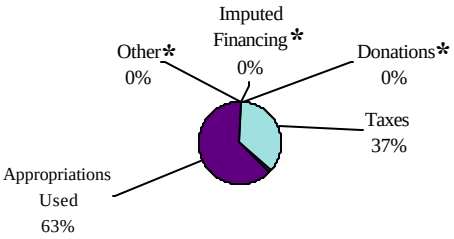
Net Position is the difference between total assets and total liabilities shown on the balance sheet. Starting in FY 1998, net position was broken down into two categories: unexpended appropriations and cumulative results of operations.

Unexpended Appropriations is the amount of authority granted by Congress that has not been expended or used. It is mostly attributed to ACF, NIH, and HCFA.

Cumulative Results of Operations are the net results of operations since inception, plus the cumulative amount of prior period adjustments. HCFA accounts for most of the balance in the account.

The Statement of Changes in Net Position begins with the net cost of operations (taken from the Statement of Net Costs) and nets these costs with all sources of financing HHS received in FY 1999 (through appropriations or otherwise) to attain net results of operations. That amount is added to the increase in the amount of unexpended appropriations to determine the change in net position from FY 1998 to FY 1999. The amount of the change is then added to the Net Position beginning balance to arrive at the ending balance of $224 billion. This statement provides more detailed information on non-exchange financing sources than can be found in other statements.

HHS FY 1999 Non-Exchange Financing Sources

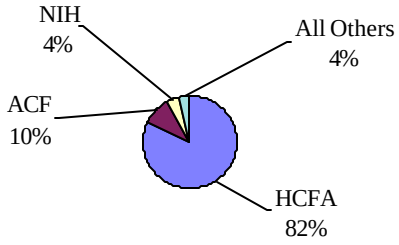


The HHS FY 1999 Statement of Changes in Net Position reveals that general appropriations and taxes are the largest source of non-exchange financing.

*** Note: Imputed Financing, Donations, and Other Financing Sources were far less than .1% of the total.**

ANALYSIS OF NET COSTS

FY 1999 Net Cost of Operations by OPDIV



HCFA, ACF, and NIH account for the largest percentages of HHS' FY 1999 Total Net Cost of Operations.

The Statement of Net Costs (which has been required for FYs 1998 and beyond) can loosely be equated with the former "Statement of Operations" which focused on how the Department's money was spent, using such categories such as grants, salaries, contracts, etc. At the Departmental level presented in this Accountability Report, the net cost of operating each OPDIV is presented in aggregate and by budget function. There is little information for analysis. Details would need to be obtained from the individual OPDIV financial statements.

The FY 1999 GPRA annual performance plans identified major programs. Those programs are shown on the OPDIVs' respective FY 1999 statements. Due to this number of OPDIV programs, presentation and analysis of cost by program will, of necessity, be at the OPDIV level. The ODPIV financial statements will be available on their respective Internet Web sites. For reporting at the Departmental level, these programs have been rolled up by budget functions. HHS's largest budget function is Medicare.

In addition, the Statement of Net Costs will allow for linking program performance under GPRA reporting to the costs of programs reflected on the OPDIVs' respective statements. The concept of linking resources to results will finally be achieved by the display of total program costs.

The format of the HHS-level Statement of Net Costs is now quite similar to the schedule of HHS FY 1999 net outlays by budget function and OPDIV (see Budgetary Highlights in Section I). The difference between the two is that the Statement of Net Costs represents expenses computed using accrual accounting techniques which recognize costs when incurred, regardless of the year the money was appropriated during the budget process. The net outlays chart in Section I identifies only the outlay (issuance of checks, disbursement of cash, or electronic transfer of funds) of those funds 'tagged' during the budget process as FY 1999 funds.

ANALYSIS OF THE STATEMENT OF BUDGETARY RESOURCES

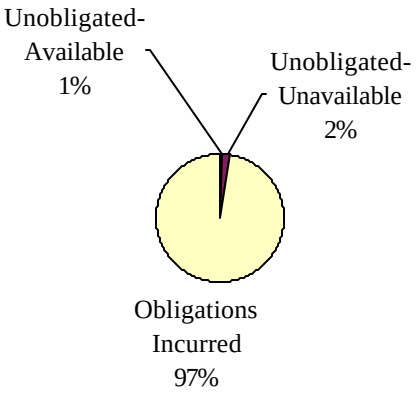
The Statement of Budgetary Resources illustrates to financial statement readers how the budgetary resources were made available and the status at the end of the period. It presents the relationship between budget authority to budget outlays and reconciles obligations to total outlays. This is a fundamental change in financial statement reporting in that the budget process became a part of the financial statement audit process when this statement was first required for FY 1998.

The purpose of the statement is to explain the sources of appropriated dollars and to provide the status (obligated or not) of those appropriated dollars. The total resources and the total status of budgetary resources equal the same amount. Thus, we have a type of budgetary "balance sheet." The statements show us that of the total $483.6 billion in FY 1999 HHS budgetary resources, they are largely derived from budget authority ($484.7 billion) and unobligated balances at the beginning of the year ($176.5 billion).

Total resources provided were reduced by a sizeable adjustment ($182.5 billion). During FY 1999, OMB revised Circular A-34, clarifying the reporting for "Adjustments" and "Unobligated balances – available" on the Statement of Budgetary Resources. The change required that "Adjustments" include the portion of receipts collected in the current fiscal year for trust funds that is precluded from obligation due to Public Law 101-508. In FY 1998, these receipts were reported as "Unobligated balances – available" (for obligation). In FY 1999, these receipts are reported as (negative) amounts on the "Adjustments" under HCFA's HI and SMI trust funds, and, additionally, HI and SMI must have no "Unobligated balances – available."The status section of the report reveals that most ($470.7 billion) of the resources budgeted for FY 1999 has either already been spent or has already been marked for specific things. Although there is an unobligated available year-end balance of $5.6 billion.

The Statement of Budgetary Resources also provides information on total outlays for the year, which is calculated by netting the beginning and ending unpaid obligations and adding the obligations incurred during the year (which is, incidentally, the same obligations incurred number reported earlier in the statement), less adjustments. Total FY 1999 outlays in the Statement of Budgetary Resources amounted to almost $451.8 billion. This amount excludes intrabudgetary transactions and proprietary receipts from the public such as those for Medicare's SMI (Part B) insurance premiums. When those amounts are included (as is practice for several budget execution reports) the figure becomes a total net outlays amount of $359.7 billion, a figure which is also used in this report (particularly in the section on budgetary highlights).

Status of Budgetary Resources at End of FY 1999



Most of the budgetary resources available to HHS during FY 1999 were categorized as incurred obligations at year end.